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Backgrounder

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# The Unintended Consequences of Housing Policy

William C. Strange

## The Backgrounder in Brief

*The provision of affordable housing is a basic pillar of a civilized society. In Canada, in recent decades, that pillar has crumbled alarmingly, as the soaring numbers of homeless people living on our cities' streets testifies. There are fiscally sound policies available for repairing the collapsing system. The overarching question is whether there is enough political will and boldness at all levels of government to seize those remedies.*

## About the Author

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Social housing appears to be returning to the Canadian political agenda. Treatments of the topic in the mass media have been extensive. For instance, the *Toronto Star*'s campaign for a "New Deal for Cities" makes frequent mention of the lack of affordable housing and the consequent need for government intervention. Governments have taken notice. For example, housing policy is cited as one of three "pillars of Canada's Urban Strategy" in a federal Liberal Caucus Task Force Report (Canada 2002). The need for social housing is noted as well by business, as reflected in a strategic report on Canada's cities by the Toronto-Dominion Bank (2002).

The case usually advanced to justify social housing is based on equity. There are two related issues. One is that some people find housing to be so expensive that they have little left over for other necessities. The Canada Mortgage and Housing Corporation (CMHC) defines 30 percent of total income as the level of expenditure beyond which housing becomes unaffordable. Using this definition, roughly a third of households in Toronto find housing to be unaffordable. Figures in other large cities are comparable.

The second equity issue is that some households respond to the high cost of housing by consuming very bad housing. In the extreme case, they are homeless. Some observers argue — often based on personal observation — that because many of the homeless are substance abusers or are mentally ill, that homelessness is not a housing problem; it is a reflection of other problems. While it is no doubt true that homelessness has some of its roots outside the operation of housing markets, it is demonstrably false to claim that homelessness arises independently from the housing market. The best evidence on this is in O'Flaherty (1996), who shows that although the de-institutionalization of the mentally ill occurred simultaneously in many places, the rise in homelessness did not. Instead, increases in homelessness accompanied increases in income inequality. This conclusion is borne out in other studies.

The case for changes in housing policy can be buttressed by considering efficiency as well. There are clearly public health externalities associated with homelessness and substandard housing. In addition, it has also been argued (Ellickson 1996), that when public spaces like parks and bus terminals become informal dwellings for the homeless, then many who are not homeless will withdraw from using these places, a kind of civic disengagement. These arguments strengthen what I consider to be an already strong equity case for addressing the housing needs of the poor.

All of this is merely to begin to make the case for some new initiatives in housing policy. This *Backgrounder* takes as given the existence of a problem and focuses on two questions that bear on the design of housing policy. The first issue is: If the goal of housing policy is to help the poor, what form should new policies take? One option is social housing — the construction, either by the private or the public sector, of new housing for low-income Canadians. Many see the decline in resources devoted to this activity as the primary cause of housing market problems, including homelessness. This is not the only option, however. Among the alternative policies, one that is at least worth considering is the provision of some kind of shelter allowance that would enable the rental of privately provided market housing. The structure and level of other forms of social assistance are taken as given, allowing the *Backgrounder* to focus on the attempts to improve affordability that

are currently being considered. The second question that the paper considers follows naturally: If government should become involved in housing to a greater degree, which level or levels of government should be given the job?

The conclusion of the analysis is that it is essential that housing policy be designed in a way that respects the incentives of private housing suppliers. Building a lot of public housing does no good at all if it leads to the destruction of similar private housing. Giving grants to a select set of low-income households may make them better off, but it is hardly helpful to the poor as a group if others who are not subsidized end up paying more for their housing. Both of these problems suggest that it is worth tackling the problems with the private supply of low-income housing directly. Fortunately, there are ways to do this. These include reducing the regulation of land use and housing supply and eliminating the unfavourable tax treatment of rental housing.

This *Backgrounder* focuses on policies that directly address housing affordability. The affordability problem is a result of housing being too expensive. It is worth pointing out that there is a different way to see the problem, with the cause being instead that incomes are too low. Taking this view, one might not want to deal with housing affordability at all, preferring instead to deal with the lack of purchasing power, which is the result of low incomes. The policies that would then come to mind would address productivity or improve the after-tax wages of low-income workers. Thus, policies designed to improve education or to lower marginal income-tax rates for low-income workers are, in a sense, affordable housing policies. Having said this, in order to maintain a manageable scope of inquiry, this paper will deal with the narrower issue of policies that directly target affordable housing.

Is the housing problem primarily an urban one that cities themselves should solve, or should federal and provincial governments play some role? If affordable housing is really a serious issue, then the case for federal and provincial involvement is compelling. The free mobility of households makes it difficult for one community to be more generous than its neighbours. Federal or provincial support may be necessary in order to prevent a race-to-the-bottom where communities are forced by the pressures of tax competition to cut back on redistribution in the housing sector.

## Approaches to Solutions

As noted, there are two broad approaches to housing policy. This section discusses the relative advantages and disadvantages of the supply-based approaches of construction subsidies and social housing and the demand-based policy of providing shelter assistance.

### *The View From the Supply Side: Construction Subsidies and Social Housing*

Construction subsidies involve the public sector providing some inducement — cash grants, loan guarantees, or favourable terms for land — in return for the construction of low-income housing. Construction may also be subsidized through the tax code. The construction of social housing involves the public sector taking full financial responsibility for building some affordable housing units. The underlying logic of these policies is that one plus one equals two: the total stock of

housing grows since there is now subsidized housing or social housing that augments privately provided low-income housing.

Unfortunately, this logic is questionable. It ignores the possibility that social housing simply displaces construction that would have taken place anyway or otherwise discourages private provision of low-income housing. In two papers, Murray (1983, 1999) shows that displacement does occur. Over a period of roughly 50 years, the construction of subsidized moderate-income housing (targeted at roughly 80 percent of median income) does not have a statistically significant effect on the total stock of low-income housing — private plus subsidized plus public. Fortunately, for low-income social housing (targeted at roughly the poverty line) this crowding-out does not appear to occur. As Murray notes, the data do not show with certainty why social housing increases the total stock, but subsidized private housing does not. One plausible explanation, advanced by Murray, is that public-housing residents, including the elderly and single-parent families, are those who might have doubled up with parents and children. Moderate- income housing residents would have instead tended to choose privately provided market housing. This result suggests the first economic lesson regarding affordable housing: Programs should be targeted at the low-income segment of the market. One way to do this would be to build small units.

In addition to having negative effects on the private supply of housing, the construction of social housing can create other problems. An obvious one is that with supply-based housing policies households are given relatively little choice of where to live. In some situations, it has been argued that the construction of social housing has been an explicit tool to preserve racial segregation. This issue is central to discussions of public housing in Chicago, as discussed in Cohen and Taylor's insightful biography of Mayor Richard Daley, *American Pharaoh* (2000). While the Canadian experience is probably gentler in this area, it is certainly true that the public construction of social housing restricts household choice.

Other social concerns have been advanced regarding the public supply of housing. One of these is that the concentration of low-income households will have negative and possibly even self-reinforcing effects on those who live there. For instance, it has been suggested that the concentration of poor households will adversely affect labour-market performance. This might manifest itself in children who grow up in environments where social housing is concentrated and those who live there experience more unemployment or earn less. The best recent evidence on this is Oreopoulos (2002), who looks at the relationship between residence and a youth in a densely settled social housing project and later labour market results. Contrary to at least some expectations, he fails to find a statistically significant difference between the labour market results of those who grew up in high-rise social housing and those who grew up in low rises that were better integrated into the larger community.

The other social concern has to do with crime. There are at least two reasons why crime might be higher in social housing than elsewhere in the community. One is that social housing deliberately concentrates low-income people, and criminal activity is higher among those with low incomes. In this case, social housing plays no role at all in causing crime, it simply results in crime being spatially concentrated. The other reason that crime might be higher in social housing is that

there are peer-group effects that influence behaviour. According to this argument, exposure to crime increases the likelihood of participating in it. In this case, social housing actually causes crime to rise. Oreopoulos (2002) also provides evidence on this, noting that the likelihood of being victimized is greater in high-density social housing than in low-density social housing.

The final problem that has been associated with social housing is its cost. Mayo (1983, 1988) argues that new construction of low-income housing is expensive. There are at least two reasons for this. One is that publicly constructed low-income housing is often of substantially higher quality than would have been available from private sources. While it is difficult to argue for low-quality social housing, it is important to recognize that the higher the quality of social housing, the fewer the units that will be constructed and the smaller the number of low-income households that receive assistance. One way to avoid this problem would be to consciously choose to build at the low-end of the market, possibly by building very small units. The other reason newly constructed low-income housing is expensive is that it does not take advantage of filtering.

Filtering is both complicated and controversial, and it is worth presenting some illustrations. One example is when an apartment building ages, it becomes somewhat less attractive than when it was new. This may lead the building to be occupied by lower-income households. Another example of filtering is when relatively low-income apartments are created out of what were formerly higher-income, single-family houses. There is a lot of filtering currently taking place. Baer (1986) suggests that approximately one-third of additions to the housing stock are something other than new construction. According to another source, there may be secondary suites in 10-to-20 percent of the single-family houses in Vancouver (Eberle and Krause 1999). The cost advantage of filtering is that it takes advantage of the existing housing stock.

The key implication of this analysis is that housing policy should not be limited to the supply side because that limits household choice, may be socially unhealthy, and has high costs.

## *Over on the Demand-Side: Shelter Allowances*

The alternative to supply-side social housing is to provide some sort of shelter allowance to needy households. The idea is to ensure that households have the financial resources to obtain private low-income housing. One advantage of demand-side policies is that they encourage the private provision of low-income housing, rather than crowding it out with construction subsidies. It is clear that this kind of program would provide greater choice than would be the case with traditional social housing. Recipients would be able to live wherever they chose. In addition, residents would also have greater choice of how to balance spending between housing and other goods.

There is debate, however, about the economy of this sort of program. Looking only at those who receive the allowances, shelter allowances are cost effective. According to Mayo (1988), a dollar of spending on social housing produces 37 cents of housing, while the same dollar would have produced 85-to-90 cents of housing

with allowances. The primary source of this discrepancy is the cost advantage of providing low-income housing through filtering rather than through new construction.

When one looks at the broader market, including those who do not receive allowances, the picture becomes murkier. The problem is that shelter allowances are likely to increase housing prices, which makes housing less affordable for the unsubsidized. The most systematic attempt to evaluate the degree of this increase is Susin (2002). He shows that communities that make more use of shelter allowances have substantially higher housing prices. Specifically, the U.S. Section 8 program of vouchers and certificates leads to a 16-percent increase in price in the private, low-income housing market. This evidence shows that considerable caution should be exercised in implementing shelter-allowance policies. In particular, the program should include all households in the target group. Otherwise, the policy actually makes things worse for some low-income households.

### *Other Approaches*

It is tempting to endorse rent control as a way to deal with the adverse effects of demand-side policies on affordability. This runs counter to the thinking of most economists, however. The problem is that rent control discourages the private supply of rental housing. Strict rent control is met with increases in demolitions and decreases in maintenance of low-income housing.

A more fruitful approach would be to directly address the ability of private builders to provide new housing. For instance, the strict enforcement of building codes increases the costs of maintaining rooming houses. Although it may be difficult for some to accept that the poor will live in low-quality housing, alternatives like living in the street are worse. In addition, in many cities, land-use regulations make filtering difficult. For instance, the in-house suites in Vancouver are nearly all illegal. If it is intended that the allowance should elicit an increase in housing supply, it makes sense to see what barriers to filtering could be eliminated. This is only a very short list of regulations that have negative effects on the affordability of housing. See the insightful papers in Fallis et al. (1995) for further discussion. Any serious attempt to improve affordability must decrease the regulatory barriers to private low-income housing supply.

These barriers are not only regulatory. Governments have consistently set the property tax rate for apartments at a level that exceeds the rate for single-family housing. This has obvious implications on affordability. Even after paying higher tax rates, governments sometimes levy user fees for water or for solid-waste disposal on apartments that single-family homeowners are spared. In order to improve affordability, governments should eliminate discriminatory taxes on multiple-family housing.

## A Problem for City Governments?

Clearly, new housing policies are needed; the question is whether those policies should be implemented by the federal government, provincial governments, municipal governments, or some combination of the three. The key to this issue is mobility. One way that mobility matters is that many poor Canadians choose to look for opportunity in big cities. As a result, a large number of urban poor are

from somewhere other than where they currently live. In this situation, it is difficult to argue that urban poverty is a problem that should be addressed only by the cities. If the poor are from elsewhere, then there is a sense in which it is fair to see urban poverty as a federal or provincial problem, the kind that warrants intervention by higher levels of government.

The other mobility issue bears on the ability of both needy households and their better-off neighbours to move in response to subsidies. The needy, it can be presumed, might be willing to move to a community that offered more generous housing subsidies. This would present an obvious fiscal challenge. The problem becomes more acute because the tax base is mobile. In a place with a lot of poor households requiring subsidies, taxes would be high. Wealthy households or businesses might choose to relocate rather than pay such taxes. For both of these reasons, solving the problem of housing affordability is one that will require federal or provincial support. It is worth noting that none of these arguments suggest that federal involvement is necessary, only that this is a problem that is too big for the cities to address themselves.

## Conclusion

What does all this have to say to policymakers? Despite the complicated nature of housing problems, I believe that there are clear lessons. They include:

*Construction subsidies or new publicly built housing should be targeted at the sort of dwellings used by the most needy.*

Otherwise, privately supplied housing will be crowded out. It may be pleasant for a politician to appear at a ceremony opening a public housing project. But if a wrecking ball in the background is tearing down similar private housing, little has been accomplished.

*If vouchers or other demand subsidies are to be provided to some low-income households, they should be provided to the entire population with similar income.*

Otherwise, the price of housing rises, and a policy designed to make the poor better off actually results in a group of poor households being worse off.

*Resist the temptation to control rents.*

This improves affordability in the short run. It destroys the housing stock in the long run.

*Land-use regulation should be made less restrictive.*

Restrictions on the ability to supply low-income housing are significant barriers to affordability.

*Property tax discrimination against rental housing should be eliminated.*

Reducing the cost of supplying low-income housing will increase supply, which will improve affordability.

These lessons are all based on the idea that housing policy can have unintended consequences. If the goal is truly to help the poor, then it is essential that policy be designed with care. The alternative would be to have affordable housing policies that do not result in more housing (like a construction program that crowds out private building) or more affordability (like a voucher program that raises prices for unsubsidized households). The road to better housing policies is littered with unintended consequences.

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